December 16, 2011

Via E-Mail

MEMORANDUM TO: Kathleen M. O'Day, Deputy General Counsel
(Board of Governors of the Federal Reserve System)

FROM: Mark J. Menting
J. Virgil Mattingly, Jr.
Jiang Liu
Sean M. Memon

RE: Scope of the Fiduciary Exemptions in Sections 3 and 4 of the Bank Holding Company Act

To implement new section 13(a)(1)(B) of the Bank Holding Company Act of 1956, as amended (the "BHC Act"), a provision of the so-called "Volcker Rule," the Board of Governors of the Federal Reserve System (the "Board") and certain other agencies have proposed rules that generally would prohibit any banking entity from acquiring or retaining, "as principal, directly or indirectly," any ownership interest in a hedge fund or private equity fund ("Covered Fund"), subject to certain exemptions.[1] The agencies' Notice of Proposed Rulemaking indicates in commentary that an ownership interest in a Covered Fund would not be deemed held "as principal, directly or indirectly" (and therefore would not be subject to the Volcker Rule's prohibition) if it were held "by a banking entity in good faith in a fiduciary capacity, except where such ownership interest is held under a trust that constitutes a company

1 *Notice of Proposed Rulemaking: Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds*, 76 Fed. Reg. 68846, 68950 (Nov. 7, 2011).

as defined in section (2)(b) of the BHC Act" (the "Proposed Fiduciary Exemption").[2] This Proposed Fiduciary Exemption precisely mirrors the fiduciary exemptions for acquisitions of bank and nonbank shares in sections 3(a) and 4(c)(4) of the BHC Act (the "Section 3 and 4 Fiduciary Exemptions").[3]

The Board has for decades interpreted the term "trust that constitutes a company" in the Section 3 and 4 Fiduciary Exemptions to mean a trust *that itself is a bank holding company* or that would become a bank holding company as the result of an acquisition. This is a well-settled Board interpretation that is fully consistent with the legislative history and purposes of the BHC Act, and there is no reason as a matter of policy that the Board should change its view.

Therefore, in accordance with this longstanding Board interpretation, a banking entity should be permitted to act as trustee of a perpetual or other long-term trust that acquires nonbank shares of any kind (including, for example, ownership interests in a Covered Fund) without applying for prior Board approval and without being subject to the prohibitions of the Volcker Rule, provided that the trust itself is not a bank holding company.

Specifically, as explained below, the Board has long recognized that the exclusions for shares held under a "trust that constitutes a company" from the Section 3 and 4 Fiduciary Exemptions were intended by Congress in 1966 to ensure that a trust that otherwise would fall within the then newly-expanded definition of "bank holding company" would not be able to avoid the restrictions and prohibitions of the BHC Act simply by selecting a bank as trustee. The exclusions were *not* intended to interfere with the traditional functions of bank

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2 *Id.*, 76 Fed. Reg. at 68896.

3 12 U.S.C. §§ 1842(a), 1843(c)(4). *See also* 12 C.F.R. §§ 225.12(a), 225.22(d)(3), the provisions of the Board's Regulation Y implementing these statutory exemptions.

trust departments in the ordinary case of a trust that is not itself a bank holding company. In addition to being inconsistent with the intent of the BHC Act and Board precedent, interpreting the Proposed Fiduciary Exemption to prohibit the holding of ownership interests in Covered Funds through a trust that is not a bank holding company would not promote safety and soundness or serve any of the public policy goals of the BHC Act. It would also greatly inhibit the ability of banks and bank holding companies to perform their core trust functions.

History of the Section 3 and 4 Fiduciary Exemptions

When the BHC Act was enacted in 1956, a "bank holding company" was defined to include any "company" that directly or indirectly owns, controls, or holds with the power to vote 25 percent or more of the voting shares of each of two or more banks. Although "company" was defined to include any business trust, trusts other than business trusts were outside the scope of this definition. Consequently, a non-business trust could feasibly acquire two or more banks and avoid the restrictions and prohibitions of the BHC Act because such a trust would not be a "company" and therefore could not be a "bank holding company."

In 1966, Congress expanded the definition of "company" in the BHC Act to include *any trust*, unless by its terms the trust must terminate within (i) 25 years or (ii) not later than 21 years and 10 months after the death of a life in being. The 1966 amendments also eliminated the exemption from the definition of "company" for certain charitable and other nonprofit organizations. The legislative history of the 1966 amendments indicates that this expanded definition was enacted in direct response to the control by one specific trust – that of the late Alfred I. du Pont – of over 30 banks together with significant nonbanking interests:

> The principal entity which now receives the benefit of the exemption for long-term trusts and which in the course of time would become a charitable institution is the Alfred I. du Pont trust fund, created under the will of the late Alfred I. du Pont. . . . The du Pont trust controls 30 banks in Florida, together with sizable nonbank businesses. . . . The principal divestiture which will be

> required by the repeal of the exemption for long-term trusts and charitable foundations will be the divestiture by the estate of Alfred I. du Pont.[4]

The legislative history further indicates that the amendments to exclude shares held under a "trust that constitutes a company" from the Section 3 and 4 Fiduciary Exemptions were intended to make clear that, notwithstanding the new coverage of a long-term trust as a "bank holding company," such a trust would not be able to avoid the prohibitions of sections 3 and 4 of the BHC Act by selecting a bank as trustee:

> The act now contains several provisions designed to permit this trust business to continue without subjecting the bank to regulation under the act simply because it acquires legal title to shares in other banks through its trust department.
>
> Since the bill would amend the act to cover long-term trusts . . . some changes must be made in these provisions to prevent their being used to achieve *exemption for the trusts involved* simply by selecting banks as trustees. Accordingly, the present exemptions in sections 2, 3, and 4 with respect to shares held by a bank in a fiduciary capacity would be amended to recognize the inclusion of long-term trusts in the definition of "company" and to incorporate references to paragraphs (2) and (3) of section 2(g), which would establish certain rules covering trust relationships . . ..[5]

This excerpt from the legislative history demonstrates that the amendments to the Section 3 and 4 Fiduciary Exemptions were focused on closing a potential loophole in those

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4 SEN. REP. NO. 1179, 89th Cong., p. 3 (May 19, 1966). *See also* H.R. REP. NO. 534, 89th Cong., p. 4 (June 21, 1965) ("The initial version of the bill (H.R. 10668, 88th Cong.) apparently would have applied to only two testamentary trusts, only one of which would have been seriously affected (because the other has only minor nonbanking interests). The one trust principally affected controls 31 banks with deposits of over $600 million, plus a number of important nonbanking businesses, including railroads, paper mills, and sizable real estate interests.").

5 SEN. REP. NO. 1179, *supra* note 4, at 6 (emphasis added). This excerpt from the Senate Report reflects the Congressional belief that, as a legal matter, when a bank acting as trustee acquires shares as trustee for a trust that is a bank holding company, the Section 3 and 4 Fiduciary Exemptions (as they existed prior to the 1966 amendments) would have exempted the entire acquisition from the requirements of sections 3 and 4 of the BHC Act, not only for the bank trustee but also for the trust on whose behalf the shares were acquired. In order to avoid this result, Congress amended the Section 3 and 4 Fiduciary Exemptions to make clear that those exemptions would not be available when a bank acts as trustee for a trust that qualifies as a company and is or would become a bank holding company.

As discussed below, in a 1969 opinion, the Board similarly expressed the view that these 1966 amendments to the Section 3 and 4 Fiduciary Exemptions were intended "to make clear that the prohibitions of the [BHC] Act are applicable irrespective of the fact that the shares were acquired for the trust by a bank in good faith in a fiduciary capacity." *See* Letter of Robert P. Forrestal, Assistant Secretary of the Board, to Daniel S. Hapke (April 17, 1969).

sections for long-term trusts that were bank holding companies or that would become bank holding companies as a result of an acquisition. The excerpt explains that the 1966 amendments to the Section 3 and 4 Fiduciary Exemptions to exclude shares held under a "trust that constitutes a company" were intended to prevent their being used "to achieve exemption for the trusts involved." The only trusts that would *need* an exemption would be those that were bank holding companies or that would become bank holding companies as a result of an acquisition. Indeed, the Senate Report is explicit that Congress intended to attribute ownership of shares held under a "trust that constitutes a company" to a bank (and indirectly to its parent bank holding company) *only* if that trust itself qualified as a bank holding company:[6]

> For example, if bank A owns a total of 30 percent of the stock of bank B under 5 separate trusts and a total of 35 percent of the stock of bank C under 10 other trusts it will not be considered a bank holding company, *as long as no single trust controls 25 percent of the stock of each of two or more banks.* And if bank A is controlled by corporation X, that corporation will not be a bank holding company, either.[7]

This example clearly reflects a Congressional understanding that the exclusions from the Section 3 and 4 Fiduciary Exemptions for shares held under long-term trusts were intended to apply only to those trusts that were themselves bank holding companies or would become bank holding companies as the result of an acquisition.

Board Precedent Interpreting the Section 3 and 4 Fiduciary Exemptions

Consistent with the preceding discussion, the Board has long held that shares held under a "trust that constitutes a company" should be attributed to a bank and its parent

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6 Although not relevant to this discussion, this also assumes the bank is not holding the shares in trust for its parent holding company and is otherwise in conformance with paragraphs (2) and (3) of section 2(g) of the BHC Act. SEN. REP. NO. 1179, *supra* note 4, at 6.

7 *Id.* (emphasis added). It is clear here that each of the trusts referred to in this example is a long-term trust that would qualify as a "company" under the 1966 amendments; otherwise, there would be no need for the proviso "as long as no single trust controls 25 percent of the stock of each of two or more banks," as such a short-term trust would not be a "company" and would not be in danger of being considered a bank holding company.

bank holding company *only* if the trust itself is a bank holding company or would become a bank holding company as the result of an acquisition.[8]

Board Interpretive Letter (1969)

In 1969, the Board issued an interpretive letter focused on this issue.[9] The Bank of St. Louis, a subsidiary of General Bancshares, a multi-bank holding company, was trustee of a perpetual trust that held more than 25 percent of the voting shares of The Bank of Steele. At the time of the letter, the perpetual trust was deemed to be a "company" under the 1966 amendments to the BHC Act, but it was not a "bank holding company" because the definition of that term did not yet include a company that controlled only one bank.

In light of the 1966 amendments, The Bank of St. Louis requested an opinion from the Board on whether the Section 3 Fiduciary Exemption was no longer available (*i.e.*, whether Board approval under section 3 of the BHC Act would be required for The Bank of St. Louis to continue to act as trustee for the Bank of Steele shares). Citing the Senate Report discussed above, the Board concluded that even though the perpetual trust was a "company," the shares held by the trust should *not* be attributed to The Bank of St. Louis or its parent holding company because the trust was not a "bank holding company":

> The Senate Report thus not only fails to reflect an intent that ownership or control of shares held in trust be attributed to the trustee bank for purposes of the Act (except under the circumstances set forth in paragraphs (2) and (3) of section 2(g), which circumstances are not involved here), but indicates that, in amending section 2(a)(A), which deals directly with the question of attribution, Congress was desirous of making clear that neither a bank nor a company that owns or controls a bank would be regarded as a bank holding company simply because of such bank's fiduciary activities. . . . [I]t appears that the intent was to

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[8] For completeness, we note here two additional statutory restrictions that must be complied with, but which are not relevant to this analysis. First, the separate restrictions of section 2(g)(2) of the BHC Act must be met. 12 U.S.C. § 1841(g)(2). Second, to qualify for the Section 3 Fiduciary Exemption, the bank must not have sole discretionary authority to exercise voting rights with respect to the shares held under the trust. 12 U.S.C. § 1842(a).

[9] Letter of Robert P. Forrestal, *supra* note 5.

prevent the exemption in section 3 from being interpreted to achieve exemption for the trusts involved simply by selecting banks as trustees.

> The situation to which the section 3 amendment seems to have been addressed is that which arises, for example, where a trustee bank is vested with discretion to invest trust funds. In such a case, if the bank should invest the funds in such manner as to cause a trust that constitutes a company to violate the Act, the amendment was intended to make clear that the prohibitions of the Act are applicable irrespective of the fact that the shares were acquired for the trust by a bank in good faith in a fiduciary capacity. But the question of the acquisition's consistency with the Act is to be judged solely on the basis of the shares owned or controlled by the trust after the acquisition, and not on the basis of other shares owned or controlled by the trustee bank or a parent bank holding company. And, since ownership or control of the trust shares is not attributable to the bank or holding company, it is unnecessary for either to apply for Board permission under section 3(a)(3). (Of course, if the trust were a bank holding company, or would become such as a result of the acquisition contemplated, the bank, as trustee, would seek prior Board approval on behalf of the trust).[10]

We note that under the facts set forth in the letter, the trust holding the Bank of Steele shares would have been classified as a "bank holding company" as a result of the 1970 amendments to the BHC Act, which expanded the definition of "bank holding company" to cover one-bank holding companies.[11] This statutory change, however, is irrelevant to the Board's interpretation of the Section 3 Fiduciary Exemption. As the Board's letter indicates, "if the trust were a bank holding company . . . the bank, as trustee, would [have sought] prior Board approval on behalf of the trust," and The Bank of St. Louis and its parent holding company would have needed to obtain Board approval to hold the shares under section 3(a) of the BHC Act.

The 1970 amendments to the BHC Act also made the Section 3 Fiduciary Exemption unavailable if the acquiring bank or company has sole discretionary authority to

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10 *Id.* (emphasis in original). The amendments to section 2(a) of the BHC Act referenced in the Senate Report extended the fiduciary exemption to a bank holding company for shares held by its subsidiary bank. Prior to this amendment, this exemption referenced only the bank, and not the parent holding company.

11 Bank Holding Company Act Amendments of 1970, Pub L. No. 91-607, § 101, 84 Stat. 1760 (1970).

exercise voting rights with respect to the shares at issue.[12] As mentioned above (*see supra*, note 8), this is a separate requirement that must be met and is irrelevant to the core question of whether the Section 3 Fiduciary Exemption is available when shares are held under a trust that is a "company" but not a "bank holding company." For example, if a bank held (in a fiduciary capacity) joint voting rights to 5 percent of another bank's shares under a perpetual trust, the Board's 1969 interpretation would still be necessary to ensure that the Section 3 Fiduciary Exemption applied, as the trust would be a "company" under the BHC Act and the Board's approval to indirectly acquire control of those shares would otherwise be required for the parent holding company of the trustee bank.

Board Rulemaking (1983)

In 1984, the Board adopted a number of amendments to Regulation Y in an effort to improve and simplify its regulations.[13] In the notice of proposed rulemaking preceding these amendments, the Board confirmed its interpretation that the Section 4 Fiduciary Exemption is available to a bank holding company subsidiary that acquires nonbank shares as fiduciary for a trust that is a "company," as long as the trust itself is not (and would not as the result of an acquisition become) a bank holding company:

> Bank holding companies and their subsidiaries are permitted under section 4(c)(4) of the BHC Act to acquire and hold nonbanking securities and activities in a fiduciary capacity so long as they are not held for the benefit of the bank holding company, its subsidiaries, or its employees. Under the BHC Act, this provision does not permit a bank holding company subsidiary to acquire nonbank securities and activities as fiduciary for a trust that is a "company" (as defined in section 2(b) of the BHC Act). *The legislative history of this provision suggests this limitation is intended to apply only where the trust is also a bank holding company. Thus, if the trust itself is not a bank holding company, the exemption is available to the bank holding company subsidiary that acts as fiduciary.* (Of course, if the trust is a bank holding company, it is subject to the

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12 *Id.* § 102, 84 Stat. 1760, 1763 (1970), amending section 3(a) of the BHC Act, 12 U.S.C. § 1842(a).

13 *Revision of Regulation Y*, 49 Fed. Reg. 794 (Jan. 5, 1984).

same limitations of this subpart with respect to its nonbank securities and activities that apply to any other bank holding company.)[14]

Policy Considerations

Because banks and bank holding companies do not invest in the trusts for which they act as fiduciary, they do not place their capital at risk, and any ownership interest held by a trust in a Covered Fund is entirely the property of the trust customer, rather than of the bank or bank holding company itself. Consequently, prohibiting a banking entity from holding an ownership interest in a Covered Fund in a fiduciary capacity under a trust that is not a bank holding company would not promote the safety and soundness of the banking entity, nor would it serve any of the public policy goals of the BHC Act, including those of the Volcker Rule.

In addition, were the Board to exclude from the Proposed Fiduciary Exemption and Section 3 and 4 Fiduciary Exemptions an ownership interest held by any long-term trust, even those that are not bank holding companies, many banking entities would not be able to effectively provide trust services to their clients. For a trust to avoid classification as a "company" under the BHC Act, it must by its terms terminate within 25 years or not later than 21 years and 10 months after the death of individuals living on the effective date of the trust. The legislative history of the 1970 amendments indicates that this formulation was enacted because, at the time of the amendments, "[m]any wills [had] been drawn to comply with the long-established legal 'rule against perpetuities'."[15] However, with many states having since modified or repealed the rule against perpetuities, and certain changes to the federal tax laws favoring the use of perpetual trusts, that no longer is the case:

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[14] *Proposed Revision of Regulation Y*, 48 Fed. Reg. 23520, 23529 (May 25, 1983) (emphasis added). The regulatory provision described herein was adopted as proposed. *See Revision of Regulation Y, supra* note 13, at 802-803.

[15] SEN. REP. NO. 1179, *supra* note 4, at 7.

> By the end of 2004, twenty states had validated perpetual trusts by abolishing the centuries-old Rule Against Perpetuities as applied to interests in trust. The driving force behind the erosion of the Rule was not a careful reconsideration of the ancient common law policy against perpetuities, but rather a 1986 reform to the federal tax code. . . . In the timeframe of our data, seventeen states abolished the Rule, implying that through 2003 roughly $100 billion in trust assets have moved [to such states] as a result of the Rule's abolition. This figure represents about 10% of the total trust assets reported to federal banking authorities in 2003.[16]

As a result of these changes in state and federal law, many bank- or bank holding company-administered trusts likely have not been created to comply with the rule against perpetuities and therefore would not qualify for the exemption from the definition of "company" in the BHC Act. Consequently, interpreting the Proposed Fiduciary Exemption and the Section 3 and 4 Fiduciary Exemptions to exclude shares held under a trust that constitutes a "company," even if that trust is not itself a bank holding company, would have far-reaching effects on bank trust activities. A bank holding company would need to aggregate banking shares held as fiduciary under *all* such trusts for purposes of determining whether an application under section 3 of the BHC Act is required; similarly, nonbank shares would need to be aggregated to determine whether an application under section 4 of the BHC Act is required. For example, a bank holding company whose bank subsidiary acts as trustee for numerous trusts would need to file an application under section 4 of the BHC Act if these trusts *in the aggregate* own 5 percent of the voting stock of any nonbank company, even if none of the trusts was itself a bank holding company. This could effectively limit the ability of banks to act as fiduciaries for trusts holding any type of shares, other than those trusts that comply with the rule against perpetuities (which, as noted above, are likely diminishing in number).

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[16] *See* Robert H. Sitkoff and Max Schanzenbach, *Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes*, 115 YALE L. J. 356 (2005) (footnotes omitted).

Conclusion

The exclusions from the Section 3 and 4 Fiduciary Exemptions for shares held under a "trust that constitutes a company" were intended by Congress to ensure that a trust that qualified as a bank holding company (or that would become a bank holding company as the result of an acquisition) could not avoid the restrictions and prohibitions of the BHC Act simply by selecting a bank as trustee. The legislative history of the BHC Act demonstrates that Congress intended the Section 3 and 4 Fiduciary Exemptions to remain available for shares held in a fiduciary capacity under a trust that constitutes a "company" as long as the trust itself was not (and would not become) a bank holding company, and the Board has confirmed this interpretation in a precedent opinion dating back to 1969 and its 1983 Regulation Y rulemaking.

This interpretation of the BHC Act's fiduciary exemptions should apply in the case of investments in Covered Funds made by a banking entity acting in a trust or fiduciary capacity, as long as the trust itself is not a bank holding company. In such a case, no funds of the banking entity would be invested in a Covered Fund or put at risk, and therefore neither the Volcker Rule's prohibition nor its purpose is implicated.

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Please feel free to contact Mark J. Menting at (212) 558-4859 or Virgil Mattingly at (202) 956-7028 with any questions or to further discuss the matters set forth in this memorandum.

M.J.M.
J.V.M., Jr.
J.L.
S.M.M.